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The Financing of Economic Growth

The Role of Private Sector Credit in Suriname

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ABSTRACT

Nothing matters more to the long-term economic welfare of a country than its rate of economic growth. The respective roles of the government and the private sector in contributing to economic growth are, however, still a subject of discussion. In the modern economic view the private sector is increasingly being considered the driving force behind real economic growth. Consequently, the government ought to facilitate the private sector by providing, among other things, a stable macroeconomic environment and a sound and competitive financial system. In this study it will be verified if the private sector indeed plays the leading role in generating economic growth in Suriname. Also, the possibility will be examined to derive a standard for the minimum percentage share of private sector credit within total domestic credit in order to realize rapid economic growth.

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I. INTRODUCTION

In this study the relationship between the monetary and the real sector, the financing of economic growth, will be considered. The identity M = DC + NFA from the IMF monetary model will serve as analytical framework, where: [1]

M = money supply;
DC = domestic credit;
NFA = net foreign assets.

The money supply will be defined as domestic liquidity (M2) since this is the relevant monetary aggregate used for policy purposes in Suriname. The focus of this study will be on the domestic component of money in relation with economic growth, although it is being acknowledged that net capital inflows may play a significant role in generating growth, especially in small open economies.

From a financial programming point of view domestic credit is subject to an overall ceiling in order to protect the balance of payments. A sub-ceiling is then imposed on credit to the government to allow for an amount of credit to the private sector that is consistent with the growth target for the economy.

In market-oriented economies credit to the private sector is normally encouraged, while that to the government is discouraged. The reason for this is that the private sector is increasingly being considered the driving force behind real economic growth. Moreover, in practice the government can not raise the necessary funds to generate economic growth adequately. As a consequence, the government runs budget deficits financed through loans, which in turn need to be repayed through government levies [2].

The distortions the government may cause in an economy through large fiscal deficits are harmful, whether they are financed in an inflationary or a non-inflationary manner. On the one hand, monetization of deficits will eventually lead to depletion of the international reserves through balance of payments deficits, and consequently to pressures on the exchange rate and the price

level. On the other hand, if net domestic money creation takes place in the presence of exchange controls, a situation of excess liquidity is inevitable resulting in inflation or, in the case of price controls, a scarcity of goods in the official market. Even if fiscal deficits are financed non-inflationary in the domestic capital market, they can eventually lead to crowding out of private investment and to pressure on the interest rate due to the scarcity of credit arising out of this type of financing [1].

In order to minimize such distortions the government ought to dispose of those tasks, which in fact can be carried out more efficiently by the private sector. However, the government should create the necessary conditions for the private sector to function productively. One of these conditions is a sound and competitive financial system with sufficient credit potential to facilitate credit to the private sector.

The purpose of this study is twofold: First, to determine whether, in the case of Suriname, domestically financed private investment is a crucial factor in realizing real economic growth. This is done by correlating the figures of real credit to the private sector and real GDP for the period 1980-1997. The outcome may serve as a guideline for the formulation of government policy regarding the domestic private sector. Second, to examine the possibility of deriving a standard for the minimum percentage share of private sector credit within total domestic credit in order to realize rapid economic growth (≥ 6%) [3]. This will facilitate the credit policy of the monetary authorities since they can exercise influence over the direction of domestic credit.

In addressing the aforementioned problem the remaining chapters in this study deal with the following:
In chapter II the classical, the Keynesian and the monetarist view on the role of the government and the private sector in an economy are summarized. In chapter III an analysis is given of the correlation between, on the one hand, real credit to the private sector and to the government and, on the other hand, real economic growth. Also, a rough standard is derived for the percentage share of the private sector in total domestic credit in order to attain rapid growth. Finally, in chapter IV concluding remarks are made.

II. SOME THEORIES ON AND CONDITIONS FOR ECONOMIC GROWTH

II.1 Introduction

Views on the role of the government in an economy are widely divergent. Some claim that the government should not only provide for collective goods, but also for various production and sales activities that are usually carried out by the private sector.

Others are of the opinion that the government should restrict its activities to some core tasks, more particularly the maintenance of law and order, social and supervisory activities and the adoption of a favourable policy towards economic growth, whereas economic activities should be left to the market [4]. Exceptions are those activities that, from a social point of view, can not be left to the market, such as the construction of roads and bridges and other works concerning the infrastructure. A favourable policy towards economic growth includes, among other things, attaining macroeconomic stability and facilitating private investment through a sound and competitive financial system.

Both views, in fact, express the core of two traditional economic theories, namely the classical theory on the one hand and the Keynesian theory on the other.

II.2 The classicist, the Keynesian and the monetarist view

In the classical view the economy is best served when each individual is free to look after his/her own interests. Prices are established by free competition and are indicative of the amount and the type of goods and services to be produced in order to meet the demand and thus bring about optimal fulfillment of needs (Say's law: each supply creates its own demand) [5].

Furthermore, the government has to refrain from interfering in the economy. In this view, it is only by free competition that the lowest prices possible will be offered, introduction of new working

methods and machines will be fostered and the most qualified manpower and the most efficient companies will be selected ("survival of the fittest"). Free competition, in which demand and supply powers are allowed to operate freely, will provide for general equilibrium in an economy.

Accordingly, Adam Smith uses in his book "An Inquiry into the Nature and Causes of the Wealth of Nations" the term "the invisible hand". With this, he argues, the individual entrepreneur will be led to take the most beneficial investment decisions, which are at the same time the most beneficial for the economy as a whole, with as the ultimate result economic growth and prosperity [5]. The system advocated by Adam Smith should, however, comply with two conditions:

1. markets should be free of government intervention;
2. there must be competition.

The Keynesian view on the other hand, which is a critical view on classical economic theory, assigns an important role to the government in fostering effective demand [5]. Effective demand is defined as the intended spending of households, the private sector and the government. In his book "The General Theory of Employment, Interest and Money", J.M. Keynes argues that the depression in the world economy in the thirties was the result of the deficiencies in total effective demand. Through a package of measures by the government, such as the construction of roads and bridges, a multiplier effect will be induced, which will increase the economic subject's tendency to spend, and consequently will lead towards economic growth. In the Keynesian view the government should increase its spending when private investment is not able to sustain economic growth, while government spending should decrease when excessive private sector spending leads to an overheated economy and consequently to inflation. Thus, the government should correct an instable private sector [6].

Milton Friedman and other monetarists also emphasize the efficiency of the private sector in comparison with the government. However, they explain the fluctuation in economic growth from a different angle. In their view the uneven changes in the money supply are the cause of fluctuations in economic growth. But most of all, they view the growth of money as the only real determinant of inflation in the short run. This is expressed in the refined quantity theory of money:

$M = (T/V) * P$ and T/V = constant, where:

M = money supply;

V = velocity of money;

P = price level;

T = trade volume.

Since V and T are considered constant in the short run, any change in M will in the monetarist view impact proportionally on P.

These opposing points of view with respect to the role of the government in the economy between classical, Keynesian and monetarist theory can not be simply qualified as right or wrong, but rather as appropriate or not. In the modern economy, where the liberal thought is rapidly gaining ground, the emphasis is, however, increasingly placed on private initiative to encourage economic growth.

II.3 Conditions for economic growth

Two important conditions that must be met in order to encourage and facilitate private investment are macroeconomic stability and a sound and efficient financial system. In both cases the role of the government is indispensable.

Macroeconomic stability implies that the government should guarantee stable prices and a stable exchange rate by means of government budget and balance of payments equilibrium. In practice, governments do not seem to be able to meet these macroeconomic objectives adequately and simultaneously, despite the specific instruments of economic policy, such as monetary, balance of payments and fiscal policy, they have at their disposal. However, due to policy trade-offs macroeconomic objectives may be conflicting. Ideal for economic growth is, however, the simultaneous and sustainable realization of price stability, full employment and balance of payments equilibrium, in other words simultaneous achievement of internal and external balance.

The financial system is, in the modern monetary economy, an essential intermediary for payment transactions and for the channeling of savings to investment nationally and internationally [7]. A financial system is efficient when the transaction, information, and risk management costs are

minimized. A financial system can be considered sound, if there exists adequate regulation and supervision on, among other things, solvency, liquidity, profitability and financial reorganization of participating institutions in order to prevent systemic risk. To this end the "Core Principles for Effective Banking Supervision" of the Basel Committee on Banking Supervision internationally serve as a guideline. The importance of an efficient and sound financial system can be summarized as follows: the more efficient and sound a financial system, the better channeling of funds to productive and profitable investments, the higher the economic growth.

III. DOMESTIC CREDIT AND ECONOMIC GROWTH IN SURINAME

III.1 Introduction

The history of the Surinamese economy is characterized by a highly irregular pattern of economic growth. The fundamental reason for this is the small production base on which the economy depends and which is dominated by the foreign-controlled bauxite sector [8]. The impact of the Dutch development aid should also not be overlooked. Thus, the economy is very sensitive to external shocks.

The extent to which economic growth developed was mainly dependent on aforementioned external factors, more particularly the international prices for bauxite products and the Dutch development aid. After the suspension of the development aid on the part of the Netherlands in 1983, the structural imbalances in the economy, such as the current account deficits of the budget and balance of payments, became apparent. When the bauxite sector suffers a decline, as it happened in 1981 when the international aluminum industry was confronted with declining prices, the Surinamese economy is affected adversely.

The analysis of the correlation between real credit (divided into government and private sector) and real GDP during 1980-1997 should take place against this background. In the case of a higher correlation between private sector credit and real GDP, we will attempt to establish a possible

standard for the minimum percentage share of the private sector within total domestic credit in order to generate rapid economic growth ($6%).

III.2 Determination and analysis of the correlation

Table 1 represents an overview of the nominal and the real domestic credit to the government and to the private sector and real GDP during 1980-1997 [9]. This table serves as an input for the determination of the percentage share of the government and the private sector in real domestic credit and the rate of real economic growth, which is shown in table 2.

TABLE 1: DOMESTIC CREDIT AND REAL GDP

	Nominal credit (mln Sf)				Real credit (mln Sf)			
End of year	Govern-ment	Private sector	Total	CPI (1980=100)	Govern-ment	Private sector	Total	Real GDP (in mln Sf)
1980	37.5	476.7	514.2	100.0	37.5	476.7	514.2	1342.0
1981	86.3	562.3	648.6	107.7	80.1	522.1	602.2	1437.3
1982	183.4	640.2	823.6	114.5	160.2	559.1	719.3	1377.0
1983	490.3	656.7	1147.0	119.2	411.3	550.9	962.2	1322.9
1984	771.4	681.9	1453.3	124.5	619.6	547.7	1167.3	1298.0
1985	1140.8	734.0	1874.8	144.0	792.2	509.7	1301.9	1324.2
1986	1590.6	772.5	2363.1	187.4	848.8	412.2	1261.0	1334.3
1987	2071.9	820.8	2892.7	285.3	726.2	287.7	1013.9	1252.2
1988	2546.4	998.3	3544.7	263.6	966.0	378.7	1344.7	1354.5
1989	2913.2	1239.4	4152.6	269.0	1083.0	460.7	1543.7	1411.4
1990	2744.7	1556.8	4301.5	353.8	775.8	440.0	1215.8	1342.0
1991	3368.3	1940.0	5308.3	460.1	732.1	421.6	1153.7	1386.0
1992	3652.7	2544.5	6197.2	724.8	504.0	351.1	855.0	1360.0
1993	5444.8	3175.8	8620.6	2354.4	231.3	134.9	366.1	1201.0
1994	5572.3	6772.2	12344.5	16162.6	34.5	41.9	76.4	1193.0
1995*	5115.1	20495.6	25610.7	22134.7	23.1	92.6	115.7	1240.8
1996*	7125.4	46094.0	53219.4	22405.3	31.8	205.7	237.5	1324.0
1997*	13135.0	65443.1	78578.1	26310.5	49.9	248.7	298.7	1397.7

Source: Central Bank of Suriname and General Bureau for Statistics.

* IMF-estimate of real GDP.

Real credit is determined on the basis of CPI at the end of each year with 1980 as base year. The sharp decline in real credit in 1994 was the result of the selective implementation of the Structural Adjustment Program (SAP) that was initiated in 1993 and resulted in the highest annual average inflation in the economic history of Suriname in the year following thereupon, namely 369 % [10].

TABLE 2: DISTRIBUTION OF REAL CREDIT AND REAL GDP GROWTH RATE

End of year	% share government in real credit	% share private sector in real credit	% change real GDP
1980	7.3	92.7	-8.6
1981	13.3	86.7	7.1
1982	22.3	77.7	-4.2
1983	42.7	57.3	-3.9
1984	53.1	46.9	-1.9
1985	60.8	39.2	2.0
1986	67.3	32.7	0.8
1987	71.6	28.4	-6.2
1988	71.8	28.2	8.2
1989	70.2	29.8	4.2
1990	63.8	36.2	-4.9
1991	63.5	36.5	3.3
1992	58.9	41.1	-1.9
1993	63.2	36.8	-11.7
1994	45.1	54.9	-0.7
1995*	20.0	80.0	4.0
1996*	13.4	86.6	6.7
1997*	16.7	83.3	5.6

Source: Central Bank of Suriname, General Bureau for Statistics and International Monetary Fund.

* IMF-estimate of real GDP growth.

On the basis of the percentage share of the government and the private sector in real domestic credit three sub-periods can be distinguished:

1. sub-period 1980-1983, in which the share of the private sector in real credit exceeds that of the government;
2. sub-period 1984-1993, in which the share of the government is greater;
3. sub-period 1994-1997, in which the share of the private sector again dominates.

The three distinct sub-periods are characteristic of the economic history of Suriname. During 1980-1983 the government made relatively less use of domestic credit, since its deficits were mainly financed via Dutch development aid. Since 1983 the share of the government in real credit exceeded that of the private sector, when the development aid was suspended. During 1983-1993

the government mainly made use of central-bank credit to finance its deficits. The years 1994-1997 were characterized by adjustment and reconstruction of the Surinamese economy, aimed at a balanced government budget, balance of payments equilibrium, a stable price level, economic growth through increased production and exports and a modern financial system.

Although the period under consideration reveals three distinct sub-periods, it is not to be recommended to determine a correlation for each of the sub-periods seperately. The results would not be useful statistically, because of the short samples. The correlation is therefore determined for the period as a whole. The result is as follows:

1. the correlation coefficient between real credit to the government and real GDP is 0.2;
2. the correlation coefficient between real credit to the private sector and real GDP is 0.7.

Statistically, a correlation coefficient of 0.7 in a sample of 18 is low. In this case, an outcome larger or equal to 0.8 would be considered reasonable. It is important to notice that for the sake of simplicity a linear relationship was assumed, which does not by any means have to be the case. The correlation coefficients clearly indicate, however, that in the period under study real credit to the private sector correlated stronger with real GDP than real credit to the government did. As was to be expected, the correlations are low because of the impact of net capital inflows (foreign investment, loans and grants). The point is, however, that from a domestic credit point of view the private sector indeed plays a much more significant role than the government in generating economic growth.

Furthermore, the data seem to suggest that, if the share of the private sector in total domestic credit is around 85 %, a growth rate of at least 6 % can be achieved given the specific conditions and constraints of the economy. The years 1980 and 1988 are, however, explicable exceptions to this rule of thumb. The negative economic growth in 1980 was caused mainly by the international oil-crisis of 1979/80, whereas in 1988 the net capital inflow to the government more than tripled due to improved relations with the Dutch, resulting in the resumption of the development aid, and to increased borrowing.

IV. CONCLUSION

Due to external factors affecting real economic growth the correlation between real credit to the private sector and real GDP turns out to be low. Still, private sector credit proves to have a much greater impact on real economic growth in Suriname than credit to the government. This is in line with the modern view regarding the role of the private sector in the economy. Accordingly, public policy should focus on facilitating the private sector by providing a stable macroeconomic environment and boosting the domestic credit potential by creating a more efficient and competitive financial sector. The "Financial Sector Reform Programme" that is presently being implemented by the Surinamese authorities is an important step in this direction. Furthermore, the authorities should, as a rough standard, allow for the allocation of at least six times more credit (≥ 85%) to the private sector than to the government if they seek to achieve rapid economic growth (≥ 6%). A stable maroeconomic environment and a sound and competitive financial system should be able to raise the level of real savings, and therefore of real investment, by offering attractive financial instruments. Domestic savings are, after all, the most important determinant in achieving sustained economic growth.

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